TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director

RE: Review of Minnesota Defined Benefit Public Employee Retirement Plan Post-Retirement Adjustment Mechanisms, Second Consideration

DATE: September 6, 2013

Introduction

As one of the topics designated by Commission Chair Senator Sandra Pappas for consideration during the 2013-2014 Interim, the Commission has scheduled a review of the post-retirement adjustment mechanisms used by the various Minnesota defined benefit public employee retirement plans.

For the Commission's second consideration of post-retirement adjustment procedures, this memo reviews procedures used in states throughout the country, including Minnesota. No attempt is made to be exhaustive, but is unlikely that any approach fundamentally different from approaches described here is used by public pension plans of any state. The material is largely based Commission staff's review of 2001 to 2012 state legislative session summaries compiled by the National Conference of State Legislatures (NCSL). Each year, the NCSL staff summarizes important public pension laws enacted in the 50 states, some of which regard post-retirement adjustment procedures. These summaries include changes in post-retirement policies, but they also provide some information on policies prior to revision.

A comment which should be made is that the short term investment climate and market value declines in 2008 strongly influenced the legislated post-retirement procedures discussed here. For many of the early years of this century, there were no post-retirement revisions worthy of being mentioned in the NCSL summaries. The activity clusters in the later years, 2008 and later. The predominant change in the post-retirement adjustment area has been to reduce adjustments, at least for the short term. It is doubtful that many legislatures throughout the country felt the changes reflect best policies for retirees. Rather, the chief driver likely was a desire to shore up pension fund finances. Some of the post-retirement adjustment procedures described in the NCSL summaries are restricted to a specified time period, set to expire unless that state's legislature takes specific action to extend or modify the procedures. Others are tied to funding condition, with higher adjustments permitted after the given pension fund again reaches a specified funding ratio or ratios.

For each of the approaches covered by this memo, Commission staff provides a brief summary of the approach, an indication of the state or states using the approach, brief discussion, and comments on the consistency of the approach with the Commission's Principles of Pension Policy.

Alternative Post-Retirement Adjustment Procedure Approaches

1. Self-Funded Cost of Living Adjustment (COLA).

    a. Example: Louisiana. The 2009 Louisiana Legislature passed a provision permitting those who retire after July 1, 2009 to choose a self-funded guaranteed permanent 2.5% cost of living adjustment (COLA) by taking an actuarial reduction. Any other COLA provided by the plan would be in additional to the self-funded COLA.

    b. Discussion. This self-funded COLA is not a true COLA. All that is altered is the pattern in which the benefits over time will be received. Consider an individual who, based on years of service and the individual's salary, is entitled to a fixed $1,000 per month for life. An individual who takes this 2.5% COLA option receives a lifetime annuity with the same value as the fixed $1,000 per month annuity. The difference is the pattern of the payments. The individual choosing this option will receive a monthly benefit less than $1,000 in the early period of annuity receipt, escalating so that in later years the monthly benefits will be more than $1,000. But the actuarial reserves (present value) for this escalating annuity must be the same as that of the level benefit annuity.

    This option serves no clear purpose and places individuals at risk. Those who happen to die before the average life expectancy will receive less benefit value than if they had taken the regular annuity.

c. Consistency with Commission Principles. This approach is totally inconsistent with the Commission's Policy Principle II.C.8., which states that benefits, which are intended to be adequate at the time of retirement, should be adjusted during retirement to fully offset the impact of inflation. This self funded cost of living adjustment changes the pattern of benefits but does nothing to offset inflation. Perhaps it is of some value for tax purposes, including for those who are not truly retired and are supplementing their income with other work during the early years of benefit receipt.

2. Delays in First Post-Retirement Adjustment.

   a. Examples: Ohio, Minnesota. For certain Ohio plans, individuals retiring in 2013 or 2014 must wait one year before receiving any adjustment, while those retiring after 2014 must wait five years before receiving the first adjustment. In Minnesota, the 2013 Legislature passed an extended waiting period for the Public Employees Police and Fire Retirement Plan (PERA-P&F). PERA-P&F members retiring after June 30, 2014 must wait three years before the first full adjustment, which is likely to be only 1%, or 25 months for a prorated adjustment.

   b. Discussion. Any delay in receiving at least a prorated adjustment can cause lost purchasing power. For Ohio employees retiring after 2014, the five year delay in receiving the first benefit adjustment will cause considerable erosion of purchasing power, particularly if inflation is high during the applicable period. For example, at 3% annual inflation, these individuals will lose about 16 percent of their purchasing power prior to the first adjustment. Minnesota PERA-P&F retirees will also be vulnerable because of the delay in the first adjustment under that plan, particularly when coupled with the minimal adjustment that plan will pay.

   c. Consistency with Commission Principles. Extensive delays in receiving the first post-retirement adjustment is inconsistent with the Commission's Policy Principle II.C.8., which states that benefits, which are intended to be adequate at the time of retirement, should be adjusted during retirement to fully offset the impact of inflation. The delays will ensure that these retirees lose purchasing power, even if it were followed with inflation matching adjustments from that first adjustment date for the remainder of retirement.

3. Investment Performance-Based Adjustments.

   a. Examples: The approach is used in Maryland, Louisiana, and Rhode Island, and in the past was used by the Minnesota first class city teacher plans.

   b. Discussion. A few related procedures fall under this general category. Some threshold of investment return or level of investment income can be used as a trigger, permitting a portion of the portfolio assets to be distributed to retirees. A specific example is the 13th check procedures used by the Minnesota first class city teacher plans in the 1980s and early 1990s. If investment income was at least 6% a specified portion of the portfolio was liquidated and allocated among the retirees. A later example in Minnesota includes the adjustments based on five year annualized rate of return in excess of 8.5%, again as used by the Minnesota first class city teacher plans.

      These approaches can provide increases to retirees, but the increases cannot be expected to match inflation. Increases are provided in years with strong investment returns, but inflation and annual investment returns are not well correlated. Over time, excessive increases might be generated for some retiree cohorts while those who retire at other times might receive increases, if any, which are inadequate to maintain living standards.

   c. Consistency with Commission Principles. This approach is not consistent with the Commission's Policy Principle II.C.8., which states that benefits should be adjusted during retirement to fully offset the impact of inflation. The approach cannot be expected to generate increases which match inflation.

4. Actuarial Reserve-Based Adjustments.

   a. Example: The former Minnesota Postretirement Investment Fund.

   b. Discussion. In its later formulations, the Minnesota Post Fund, which prior to its dissolution generated post-retirement adjustments for Minnesota State Retirement System (MSRS), Public Employees Retirement Association (PERA), and Teacher Retirement Association (TRA) retirees, in part provided increases based on whether there were actuarial reserves in excess of those needed to support the existing benefit levels. This approach might be considered a subset of the investment performance based approach described above. If there were high returns, asset values in excess of needed annuity reserves might be generated, permitting increases beyond the capped inflation match. But a key difference between this and the first class city teacher plan approach was that the Post Fund was asset based, rather than being directly rate of return based. If the Post Fund lacked sufficient assets to support further increases, as would occur after a string of below average investment returns, no adjustment beyond the capped inflation match was provided until the assets were built up sufficiently to support increases. The Post Fund therefore had a shut off valve which the first class city teacher plan procedures lacked.

An actuarial reserve-based adjustment mechanism can provide increases to retirees, but the increases will not match inflation. Particularly if complemented by a capped inflation match provision, excessive increases might be generated for some cohorts of retirees, while those who retire at other times might receive increases which are inadequate to maintain living standards.

c. Consistency with Commission Principles. This approach is not consistent with the Commission's Policy Principle II.C.8., which states that benefits should be adjusted during retirement to fully offset the impact of inflation. Actuarial-reserves based adjustments cannot be expected to generate increases matching inflation.

5. Reduced Benefit Multiplier (Accrual Rate) in Exchange for Higher Cost of Living Adjustments.

a. Example: Kansas.

b. Discussion. For one or more Kansas plans, the Kansas Legislature revised the plan structure to provide lower benefits at the time of retirement in exchange for higher post-retirement adjustments. This move is the opposite of what occurred in Minnesota in 1997, when the inflation match portion of Post Fund increases was revised downward from 3.5% to 2.5%, to finance higher benefits (increased accrual rates) at the time of retirement.

c. Consistency with Commission Principles. Whether lowering accrual rates in exchange for higher post-retirement adjustments is compatible with the Commission Principles depends on details of the changes that were made. Commission Principle II.C.7.b. states that retirement benefits should be designed to be adequate at the time of retirement, and Principle II.C.8.a. states that benefits during retirement should be revised to keep pace with inflation. Lowering accrual rates, which along with salary and service credit determines the benefit at the time of retirement, might be consistent with Commission principles if the previous law was producing benefits which were excessive, and if the revised benefit levels are consistent with benefit adequacy. The higher post-retirement adjustments might be consistent with Commission principles if the revised adjustment system was an inflation match. To the extent that it differs, it would be inconsistent with Commission principles.

6. For Currently Active Employees, Eliminating Post-Retirement Adjustment System in Exchange for Higher Benefit Multiplier (Higher Accrual Rate).

a. Example: Kansas.

b. Discussion. In another situation, the Kansas legislature increased benefits at the time of retirement, but eliminated the post-retirement adjustment system. The revisions applied to current employees.

c. Consistency with Commission Principles. This approach is not consistent with Commission principles regarding benefit adequacy at and during retirement. If the new accrual rate provided benefits that are deemed adequate at retirement, the benefits would quickly become inadequate during retirement due to the lack of any adjustment to offset lost purchasing power during retirement due to inflation. Those retired many years would suffer seriously losses in purchasing power. Perhaps the intention was to provide an excessive benefit at retirement, so that the erosion of purchasing power would not become a serious concern until many years later, when the Kansas Legislature and the pension fund might be in a better financial position to address the faulty procedures.

7. Reducing or Eliminating Post-Retirement Adjustment System for New Employees or Certain Active Employees.

a. Examples: Connecticut, Florida, Hawaii, Georgia.

b. Discussion. Connecticut and Hawaii lowered adjustments applicable to current employees who retire after specified dates, or to new employees. Georgia will provide no post-retirement adjustments during retirement for anyone hired after July 1, 2009. Florida passed revisions applicable to new and existing employees and will pay no adjustments relating to service provided after July 1, 2011.

c. Consistency with Commission Principles. Any post-retirement adjustment mechanism which fails to provide adjustments matching inflation is inconsistent with Commission Principle II.C.8.a. The Georgia and Florida provisions, which will eventually end all post-retirement adjustments, are the most harmful and least consistent with the Commission's policy statement.

8. Post-Retirement Adjustments Escalating with Years in Retirement.

a. Example: Nevada.

b. Discussion. Given revisions in certain Nevada plans, new retirees will receive very low percentage increases in their annuities, escalating with each additional year in retirement until the individual has been retired 12 years, at which point an ultimate 4% annual increase is reached. The 4% annual increase will be provided each year thereafter.

The policy justification behind this design is not apparent. The approach appears to provide specified, escalating percentage increases, none of which are tied to inflation. In early years it is likely that individuals will lose purchasing power, while increases in later years are likely to be in excess of inflation. An individual who retired at age 65 would be nearly 80 before reaching the ultimate 4% benefit adjustment level. Retirees might be better served with more purchasing power earlier in their retirement years.

c. Consistency with Commission Principles. This approach is not consistent with the Commission policy principles. The escalating pattern of adjustments, none of which are tied to actual inflation, is not compatible with the Commission's statement calling for an inflation match.

9. Increases Capped by Annual Dollar Amount.

a. Examples: Maine, Ohio, South Carolina.

b. Discussion. Maine, Ohio, and South Carolina placed a dollar cap on annual post-retirement adjustments, presumably with that cap indexed to inflation. For example, if a $500 cap is in place, any annual benefit that would otherwise increase by more than $500 would be capped at $500.

The impact of this change depends on the systems in place prior to adding this cap, the level of the cap, and actual inflation rates. If a dollar cap is added to a plan that provided fixed percentage increases to annuitants, the number of annuitants impacted will depend on the specific cap amount. A high cap will impact few, a low cap considerably more. For a plan which provides an inflation match but with a dollar cap, few annuitants might be negatively impacted if the cap is high and inflation is low.

If a dollar cap is not indexed, it will impact more and more people over time. If the intention is to avoid this effect, the amount of the dollar cap would need to be indexed.

Some might argue that individual's subject to a given cap are those with the most resources, who are least truly harmed by a cap. This is not necessarily the case. First, some subject to the cap might be quite elderly and have exhausted other financial resources. Second, the size of an individual's annuity might be a poor proxy for wealth. An individual might have a relatively low annuity from a plan, and thus be below the cap, because the individual did not have much service covered by the plan. Much of the individual's career might have been in the private sector, and the individual might have considerable retirement assets due to that other employment. Similarly, the cap approach might not well address retirees who were job mobile within the public sector. An individual with considerable service in one plan might be subject to the cap, while an individual with similar salary and service, but who changed employment within Minnesota public employment, might not, because benefits would be provided by two or more plan systems.

Special consideration would also need to be given to whether an individual is covered by a coordinated plan or a basic plan. A coordinated plan is one where, in addition to coverage by the Minnesota plan, the individual is covered by Social Security for the Minnesota public employment. A basic plan is one where there is no Social Security coverage. Most Minnesota public employees are in coordinated plans. These plans have relatively low contribution rates but also provide relatively low benefits, in recognition that the individual also has Social Security coverage. In contrast, the State Patrol Retirement Plan and PERA-P&F are basic plans. These plans have a high benefit multiplier per year of service, in recognition that there is no corresponding Social Security coverage. If the Commission were to consider imposing a dollar cap on annual post retirement increases, basic plan retirees are more likely to be subject to the cap than coordinated plan retirees, unless different caps are used for each type of plan.

c. Consistency with Commission Principles. This approach is not consistent with the Commission's policy principles. Even if a plan had been providing an inflation match, imposing a dollar cap on benefit adjustments is a step away from that policy.

10. Adjustments on Annual Benefit Amounts up to a Specified Dollar Amount, and Lower Adjustments (or no Adjustment) on Benefits Above That Dollar Amount.

a. Examples: Maine, Massachusetts, Rhode Island.

b. Discussion. Maine has plans which provide higher annual adjustments up to a specified benefit amount, and lower adjustments on benefits above that limit. Massachusetts will provide no increases on annual benefit amounts in excess of $13,000. Rhode Island will adjust only the first $35,000 in benefits.

These approaches assume those receiving smaller annual benefits need more protection than those receiving higher benefits. This is contrary to the notion that inflation impacts all of us, and the best way to address that for all retirees is to offset inflation.

If the Commission were to consider implementing a variation of these approaches, for reasons discussed previously the Commission would need to consider using different dollar triggers depending upon whether the plan is basic or coordinated. Another consideration would be devising appropriate treatment for an individual whose service is all in one plan, compared to a similar individual with portions of her total service covered by different plans. For the second individual, the sum of the annuities from the separate plans may be comparable to the annuity of the first individual from a single plan. Unless the procedures were carefully structured, the first individual might be subject to lower adjustments on a portion of the annuity, while the second individual might slip under the radar. Even if the combined-service individual is identified, devising comparable treatment would be challenging because all consistency in post-retirement adjustment procedures has broken down due to post 2009 legislation. Different plan systems are providing different post-retirement adjustments. Even within a plan system such as MSRS or PERA, different plans are providing different adjustments.

c. Consistency with Commission Principles. This structure is inconsistent with the Commission's principles. By increasing low annual benefit annuities at one rate and higher annual benefit annuities at a lower rate for a portion of the high value annuity, the result is not consistent with adjustments matching inflation.

11. Benefit Adjustment Eligibility Tied to Poverty Level.

a. Example: Ohio public safety plan.

b. Discussion. For an Ohio public safety plan, plan retirees will be guaranteed a full 3% fixed rate post-retirement adjustment if the person's annual benefit amount is less than 175% of the federal poverty level. Others may receive lower adjustments.

c. Consistency with Commission Principles. This structure is inconsistent with the Commission's policy principle which calls for inflation matching adjustments for all annuitants. First, a fixed 3% rate will not agree with annual fluctuations in the inflation rate, and may not be consistent with the long-term average inflation rate. Second, paying different rates of adjustment to those with lesser annual benefits compared to those with higher benefits is inconsistent with the Commission's statement; some individuals may be kept whole, or more than whole, while others are not.

12. Non-Compounded Adjustments to Specified Age (or No Adjustments), Compounded Adjustments Thereafter.

a. Examples: Illinois, Louisiana, and Mississippi. Mississippi provides non-compounding increases prior to age 55 and compounding increases thereafter. Louisiana provides no adjustment before age 60, while Illinois will provide no adjustments prior to age 67.

b. Discussion. In certain Mississippi plans, retirees younger than age 55 receive 3% annual adjustments, but these are not compounded. After age 54, 3% adjustments are paid which do compound. For example, if an individual age 52 was paid a benefit of $1,000 per month, the person would receive an additional $30 as a post-retirement adjustment, for a total of $1,030 per month. Next year the individual would still receive a total of $1,030 per month. Once age 55 is attained the adjustment is added to the base and begins to compound. The monthly benefit would increase to $1,060.90 ($1,030 x 1.03 = $1,060.90). The following year the monthly benefit will be $1,092.73, and so on.

The motivation for this structure is unclear. Perhaps Mississippi was trying to limit plan liabilities and discourage early retirement. But it may not have much impact, at least under recent inflation conditions. Presumably it is a rare individual who retires much before age 55. For those who retire from the plan somewhat before age 55, the lack of compounding may not provide much discouragement in a low inflation environment. If inflation is well under 3%, the individuals may be kept more than whole by a non-compounded 3% adjustment. Similarly, once age 55 is attained and the 3% adjustments begin to compound, the adjustments are in excess of current inflation.

Regarding the other two examples mentioned, the Louisiana decision to pay no adjustment prior to age 60 may be intended to discourage early retirement, but a more direct and effective way would be to raise the minimum early retirement age and require actuarial reductions for early retirement. The Illinois situation, where no adjustments will be paid prior to age 67, appears motivated primarily by a desire to trim liabilities.

c. <u>Consistency with Commission Principles</u>. The approaches are inconsistent with the Commission's principles as the approaches are not targeted to offset inflation. In general they may under compensate or over compensate retirees. The youngest retirees, however, particularly in the Louisiana case, are left vulnerable to the eroding impact of inflation.

13. <u>Post-Retirement Adjustments Matching Rate of Salary Increases for Active Plan Members</u>.

a. <u>Examples</u>: This system is currently being used for the Maryland Judges and Legislators Plans, and was extensively used in Minnesota for local police and paid fire plans.

b. <u>Discussion</u>. Under this approach, plan retirees receive a percentage increase equal to the percentage increase in active duty salary. If active Maryland judges and legislators received salary increases which matched inflation, so would be retirees. If the increases were either less than inflation or more than inflation, retirees would similarly receive adjustments which were more or less than needed to maintain purchasing power. The frequency of increases (or more likely the lack of frequency) is also an issue. If Maryland is like Minnesota, legislator and judicial salaries are rarely adjusted. Retirees could go many years between adjustments.

When the salary-based adjustment approach was used in Minnesota local police and paid fire plans, the plan retirees received an increase equal to the percentage increase in the salary of a top grade patrol officer or firefighter covered by the applicable local relief association plan. Salary adjustments for the applicable position were impacted by the market forces of supply and demand, by increasing productivity, and by the labor negotiation process. Presumably, both sides realized that the specific salaries set for the top grade police office and firefighter position had particular significance, because those salary increases drove post-retirement adjustments. An issue which arose in these negotiations, or later in the way the pension plan administrators ran to plan, was disagreements about what ought to constitute salary for purposes of the target position. In Minneapolis, for example, disagreements arose regarding whether certain overtime pay, clothing allowances, shift differentials, payments for police canine care, and other elements were properly includible in the applicable top grade salary.

c. <u>Consistency with Commission Principles</u>. Only by chance is this approach consistent with the Commission policy principle that post-retirement adjustments should match inflation, because there are many reasons why the salary use to adjust pensions may not increase (or decrease) at the same percentage as the inflation rate. Use of a salary which is infrequently changed would cause problems, because retirees could go long periods without any adjustments.

14. <u>Fixed Percentage Increase</u>.

a. <u>Examples</u>: Minnesota plans invested by the State Board of Investment prior to the 2010 Financial Sustainability revisions, to be reinstated for many of these plans once financial stability is regained. Fixed percentage increases are also used by numerous other states.

b. <u>Discussion</u>. The impact of a fixed percentage increase for retirees depends on the level of the increase. If the intention is to provide some minor increase to retirees, to offset some but not all of the impact of inflation, retirees will lose ground over time to inflation. The level might also be set too high, being more than sufficient to offset inflation. There is an argument for generous adjustments if the benefit at the time of retirement is inadequate. But a far more straightforward approach, and one that will be more successful overall, would be to create a pension that is adequate at the time of retirement, with post-retirement adjustments matching inflation. A third possibility is to set the fixed adjustment at what is believed to be the long term inflation rate. This might provide good results in the long term, but there are some qualifiers. The estimate of the long term inflation rate is an educated guess, which might over time prove to be incorrect. A fixed percentage increase, set at the estimated long term inflation rate, may provide goods results if the estimate of inflation proves to be correct. An adjustment procedure which instead matches inflation in each year is certain to produce the desired result, and does not depend on the accuracy of a long-term projection.

A further problem with fixed percentage increases, even if it does match the long term inflation rate, is that it will produce somewhat different results for each individual. Whether any given individual is kept whole will depend on when that individual retired, when he leaves the system through death, and the actual annual inflation rates between those dates. An individual who retires at the beginning of a high inflation period might never be made whole if death occurs before a prolonged period of less than average inflation.

c. Consistency with Commission Principles. Fixed percentage increases might be generally consistent with the Commission's principle of keeping retirees whole, if the fixed adjustment matches the long term inflation rate. Fixed percentage increases which are too low will under compensate, while adjustments which are too high will over compensate. A better approach would be to have annual adjustments matching inflation.

15. Lower Percentage Adjustments, or no Adjustment, to be Increased When Certain Funding Ratios are Met.

a. Examples: Arizona, Minnesota, New Jersey, Rhode Island, South Dakota. Many Minnesota plans recently (generally in 2010) lowered the percentage adjustments they provide to retirees, to be replaced by either a higher fixed percentage adjustment when funding stability is attained, or in some plans by a capped inflation match. Arizona and South Dakota are also using fixed adjustments which increase when higher funding ratios are attained. The Minnesota TRA used a more extreme approach; suspending adjustments for two years followed by low percentage adjustments until funding stability is achieved, at which point 2.5% annual adjustments will be reinstated. Some Maine and Florida plans are using an approach similar to the Minnesota TRA. New Jersey and Rhode Island terminated post-retirement increases, to be reinstated when certain funding ratios are attained. The St. Paul Teachers Retirement Fund Association (SPTRFA) also suspended adjustments, but that was only for one year.

b. Discussion. In Minnesota, these closely related approaches were created by the 2010 Financial Sustainability Measures and subsequent legislation. These are interim procedures. Given the situation following 2008, plan administrators and the Legislature placed higher priority on reducing fund outflow to shore up funding levels than maintaining retiree purchasing power. Higher percentage adjustments will again be paid when the funding ratio targets used to defined funding stability in the legislation are attained.

c. Consistency with Commission Principles. The Legislatures decision to lower percentage adjustments to retirees, to be increased when certain funding ratios are met, reflects a temporary legislative decision to emphasis helping the plans rebuild their asset base. Other objectives, such as the policy objective to keep retirees whole, have been placed on the back burner. Fortunately, inflation has been modest.

16. Blink-on/Blink-off Procedure: Increases Suspended if Funding Ratio Falls below Target Ratio, Restarted if Ratio is at Least Equal to Target.

a. Example: Minnesota Duluth Teachers Retirement Fund Association (DTRFA). The DTRFA has a blink-on/blink-off procedure. Once a 90% funding ratio is achieved, the DTRFA is authorized to pay a 5% inflation match, but no adjustment will be provided in a year in which the funding ratio has dipped below 80%. New Jersey and Rhode Island are also using a blink-on/blink-off procures for their adjustments.

b. Discussion. Blink-on/blink-off procedures serve to maintain the plan asset base, but it comes at the expense of retirees. In the DTRFA case, even if inflation never exceeds the 5% cap, retirees will lose purchasing power whenever the inflation match blinks-off. There is no process in the law to pay an adjustment in excess of inflation in any subsequent year to any retiree to compensate for an adjustment missed because of the blink-off.

c. Consistency with Commission Principles. A blink-on/blink-off procedure is inconsistent with the Commission's principle of maintaining retiree purchasing power, because no adjustment will be paid to the retiree in a year where the funding ratio has fallen below the target threshold. This could be offset in a future year or years if it were possible to pay an adjustment or adjustments in excess of inflation, but that was not included in DTRFA post-retirement adjustment law.

17. Capped Inflation Match.

a. Examples: Some plans in Colorado, Connecticut, Hawaii, Illinois, Maine, Maryland, North Carolina, Ohio, Utah, and some Minnesota plans have capped inflation match provisions. For the Minnesota plans, in general adjustments have not occurred under capped inflation match provisions because funding ratios needed to begin paying these capped adjustments have not yet been attained. Once the necessary funding ratios are attained, the Minnesota SPTRFA and DTRFA will match inflation up to 5%, while PERA-P&F will match inflation up to 2.5%. Regarding some examples from other states, Utah will provide an inflation match up to 4%, rather than up to 2.5%. North Carolina and Ohio replaced systems which paid fixed 3% increases with an inflation match, not to exceed 3%. Illinois is more restrictive, instituting a system under which increases will be half the inflation rate, not to exceed 3%.

b. Discussion. Capped inflation matches, to be used by certain Minnesota plans, reflect a compromise between keeping retirees whole while maintaining the plan asset base. Legislators might have been concerned that uncapped adjustments would jeopardize the fund asset base in a period of low investment returns but high inflation. However, it is clear that individuals will not be kept whole by a capped inflation match if actual inflation exceeds that cap. There are no provisions in law to exceed an inflation match in any subsequent year for those individuals who were short changed by inflation exceeding the cap. Given the lack of a make-whole provision, a fixed percentage increase set at expected long-term inflation may have an advantage over a capped inflation match. In some years of lower inflation, a fixed percentage increase may provide more than is needed to offset inflation for the year, but the excess can offset prior losses of purchasing power due to years where actual inflation exceeded fixed percentage adjustment.

A system like that instituted in Illinois, where adjustments will only cover half the inflation rate, not to exceed 3%, is sure to cause loss of purchasing power whether inflation is low or high.

c. Consistency with Commission Principles. By itself, a capped inflation match as will be used by certain Minnesota plans is not fully consistent with the Commission's policy principle that retirees should be kept whole during retirement by inflation matching adjustments. The retiree will not be kept whole if inflation exceeds the cap. The 5% cap that will be used by the SPTRFA and DTRFA is more consistent with the Commission's policy statement than the PERA-P&F 2.5% capped adjustment provision. Inflation is less likely to exceed a 5% cap than a 2.5% cap.

A system like that in Illinois, where at most half of inflation will be covered by the adjustments, is even further removed from consistency with the Commission's policy.

18. Inflation Match.

a. Example: A few Maryland plans (State Patrol and correctional plans) and Vermont have an inflation match without a cap.

b. Discussion. The Maryland State Patrol and correctional plans use an inflation match, and it appears to be without a cap. The Vermont provision, enacted in 2008, will provide an uncapped inflation match and applies to those who retire after June 30, 2008.

c. Consistency with Commission Principles. An uncapped inflation match is fully consistent with the Commission policy principle.